

# ANALYSIS OF ORIGINAL BILL

## Franchise Tax Board

Author: Ackerman Analyst: John Pavalasky Bill Number: SB 1172  
Related Bills: See Legislative History Telephone: 845-4335 Introduced Date: February 4, 2004  
Attorney: Patrick Kusiak Sponsor: Franchise Tax Board

**SUBJECT:** Nonresident Taxation/Federal Preemption

### SUMMARY

This bill would provide expressly that California is conformed to federal statutes that limit or preempt California's ability to tax the California source income of specified nonresidents.

### PURPOSE OF THE BILL

This bill would prevent lengthy and expensive litigation to validate the preeminence of federal law.

### EFFECTIVE/OPERATIVE DATE

This bill, if enacted in 2004, would become effective January 1, 2005, and would apply to taxable years beginning on or after that date.

### POSITION

Support.

On December 2, 2003, the Franchise Tax Board (FTB) voted 2-0 to sponsor the language contained in this bill with the representative of the Department of Finance abstaining.

### ANALYSIS

#### FEDERAL/STATE LAW

##### Current Federal Law

The federal Constitution is the "supreme law of the land" and provides that federal constitutional provisions "trump" conflicting provisions of any state's laws or constitution.<sup>1</sup>

<sup>1</sup> U.S. Const., art. VI, section 2.

Board Position:

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|-----------------------------|------------------------------|---|
| <input type="checkbox"/> S  | <input type="checkbox"/> NA  | <input type="checkbox"/> NP                 |
| <input type="checkbox"/> SA | <input type="checkbox"/> O   | <input type="checkbox"/> NAR                |
| <input type="checkbox"/> N  | <input type="checkbox"/> OUA | <input checked="" type="checkbox"/> PENDING |

Department Director

Date

Gerald H. Goldberg

3/8/04

There are a number of federal statutes that limit or preempt California's ability to tax the California source income of nonresidents.<sup>2</sup>

In the case of a nonresident who performs regularly-assigned duties while engaged as a pilot, master, officer, or crewman on a vessel operating on the navigable waters of more than one state, California cannot tax any of the income from that employment. Only the state of residence may tax this income.<sup>3</sup>

In the case of a nonresident employee of an air carrier (airline), California can tax a nonresident employee's California source income from that employment only if more than 50 percent of the pay received by the employee is earned in California.<sup>4</sup>

In the case of a nonresident employee of a railroad who performs services in two or more states, California cannot tax any of the income from that employment. Only the state of residence may tax this income.<sup>5</sup>

In the case of a nonresident employee of an interstate motor carrier (truck or bus driver) who performs services in two or more states, California cannot tax any of the income from that employment. Only the state of residence may tax this income.<sup>6</sup>

In the case of a nonresident member of the armed forces stationed in California, California may not tax any of the income from military service performed in California.<sup>7</sup> Only the state of residence may tax this income.

### Current State Law

The California Constitution provides that a California administrative agency may not refuse to enforce a California statute because of a federal law or federal regulation, unless an appellate court has determined that enforcement of the California statute is prohibited by federal law or federal regulation.<sup>8</sup>

The California Attorney General has stated, in another context, that, with respect to federal preemption of conflicting State statutes, article III, section 3.5 of the California Constitution must fail because of federal supremacy.<sup>9</sup>

The California Constitution also provides that a California court may not take any action to prevent or enjoin the collection of tax. Only after payment of tax may a court action be maintained to recover tax and interest paid.<sup>10</sup>

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<sup>2</sup> It is noted the federal statutes considered deal with interstate commerce (see U.S. Const., art. I, section 8, cl. 3) and the military (see U.S. Const., art. I, section 8, cl. 11-13).

<sup>3</sup> 46 U.S.C. section 11108(b).

<sup>4</sup> 49 U.S.C. section 40116(f)(2)(B).

<sup>5</sup> 49 U.S.C. section 11502(a).

<sup>6</sup> 49 U.S.C. section 14503(a)(1).

<sup>7</sup> 50 U.S.C. Appen. Section 574.

<sup>8</sup> Cal. Const., art. III, section 3.5.

<sup>9</sup> 68 Ops.Cal.Att.Gen. 209, 219-222 (1985).

<sup>10</sup> Cal. Const., art. XIII, sec. 32. Revenue and Taxation Code section 19381 provides for suit in Superior Court to determine residency without payment of tax.

California taxes nonresidents only on income from California sources.<sup>11</sup> However, no California statute explicitly establishes rules to source income. Instead, the relevant California statute delegates to the FTB authority to prescribe sourcing rules by regulation.<sup>12</sup>

These regulations provide that services are sourced to California to the extent the services are performed in this State.<sup>13</sup> When nonresidents perform services in California and other states, compensation for these services is sourced to California by using various apportionment methods that reasonably reflect the value of the California services as compared to the total services performed. These regulations are interpreted by department staff to be consistent with federal statutes that limit or preempt California's ability to tax the California source income of nonresidents.<sup>14</sup>

With respect to a nonresident member of the armed forces stationed in California, the California Legislature confirmed by statute in 1986<sup>15</sup> that none of the income from military service performed in California is included in gross income even with respect to a resident spouse under community property law or rules.

In 1996, Section 114 of Title 4 of the United States Code was enacted to limit state income taxation on a source basis with respect to certain pension income. During that same year, California enacted a conforming provision<sup>16</sup> that, for 1996 and later years, specifically provides that gross income of a nonresident from sources within this state does not include "qualified retirement income." This conforming section applies only during the period that the provisions of Section 114 of Title 4 of the United States Code, relating to limitation on state income taxation of certain pension income, are effective.

## THIS BILL

This bill would amend the Revenue and Taxation Code to provide expressly that California is conformed to federal statutes that limit or preempt California's ability to tax the California source income of certain nonresidents, i.e., those employed in interstate commerce and members of the armed forces.

## **LEGISLATIVE HISTORY**

AB 850 (Ch. 506, Stats. 1996) enacted the Morrissey Retirement Income Protection Act, which exempts non-resident pension income from tax in conformity with federal law.

## **OTHER STATES' INFORMATION**

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws.

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<sup>11</sup> Revenue and Taxation Code section 17951.

<sup>12</sup> Revenue and Taxation Code section 17954.

<sup>13</sup> Cal. Code. Regs., tit. 18, section 17951-5.

<sup>14</sup> *Id.* Various apportionment methods are used.

<sup>15</sup> Revenue and Taxation Code section 17140.5.

<sup>16</sup> Revenue and Taxation Code section 17952.5.

None of these state's constitutions contain any provision comparable to the California Constitution's provision that a California administrative agency may not refuse to enforce a California statute because of a federal law or federal regulation, unless an appellate court has determined that enforcement of the California statute is prohibited by federal law or federal regulation. (Cal. Const., art. III, section 3.5.)

## **FISCAL IMPACT**

No departmental costs are associated with this bill.

## **ECONOMIC IMPACT**

### Revenue Estimate

This bill would not impact the state's income tax revenue. An examination of actual state tax returns did not show any taxpayers claiming this exclusion. It is assumed that, in general, the pro-rata share of income of nonresident interstate commerce employees who travel into California and provide a service is below the filing threshold.

## **LEGAL IMPACT**

California law regarding the taxation of nonresidents on income from California sources could be interpreted to conflict with federal statutes that limit or preempt a state's authority to tax certain nonresidents, i.e., those employed in interstate commerce and members of the armed forces. This bill would ensure that the FTB is in full compliance with the requirements of the Federal and California Constitutions.

## **LEGISLATIVE STAFF CONTACT**

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